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A. M. Pullen & Company

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Contents

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LYBRAND JOURNAL

Foreword

Just a year ago, Mr. Defliese informed all Partners, Managers and Supervisors of an arrangement reached between our Firm and the well known and widely respected Firm of A. M. Pullen & Company. The agreement provides for an exchange of mutual capacities whenever it is in the interest of clients of the respective Firms.

We were happy to have Mr. G. E. Perrin, the Managing Partner, and Messrs. Bretnall and Eichhorn, two of the other Partners of A. M. Pullen & Company, as guests at our Firm meeting at Seaview this spring.

Mr. Defliese and I were privileged to attend the annual partnership meeting of the Pullen Firm which was held in June at The Cloisters, Sea Island, Georgia. Both of us found the papers presented of such interest that we asked for and received permission to make them available to our own organization through this special issue of the *Journal*. I am sure you will enjoy reading them. As you do, perhaps you will be impressed, as I was, with the close similarity of the subjects with those in which we, too, have a keen and continuing interest.

A. R. Jennings

Compensation Plans

By *Forrest W. Brown, Jr.*
A. M. Pullen & Company, Richmond Office

There is probably no subject of more general interest to our clients than compensation. Unfortunately, compensation is taxable income and a high salary coupled with a bonus based upon the results produced is no longer enough to attract or keep highly compensated executive talent.

As one writer says, "The man who said a bird in hand is worth two in the bush never heard of the income tax." The executive may be far more interested in the manner of payment and the time of payment than in the dollar amount of payment. The tax laws have forced the negotiation of compensation plans into a complex pattern by high tax rates and have then created certain situations in which the full force of these rates is not felt.

There are very few methods to lessen the impact of Federal tax on income received. The most obvious is to have nontaxable income. If nontaxable income is not possible, our clients will accept taxable income if it comes in the form of long-term capital gain. If both these possibilities are lacking, they will accept fully taxable income, but will aim at deferring receipt until a year when the tax will be at a minimum. All these possibilities are present in various forms in compensation plans.

The simplest form of incentive plan is the basic salary with a bonus based on performance. Its appeal is in its direct approach and its immediate results to the recipient. To the younger executive to whom immediate income is most important, this plan may be acceptable or even preferable. This plan, however, lacks any tax benefits and will here be considered only as an alternative to be offered the individual.

Beyond this plan are the various forms of deferred compensation plans. In the broad sense, deferred compensation is any delayed payment for services and in this sense, would include qualified pension and profit-sharing plans. The Internal Revenue Code provides, in Section 404, for deductions for contributions to both the qualified plans and other forms of deferred compensation. Payments under Section 404 must still meet the test of reasonable compensation.

To secure the maximum tax advantages the employee will have to adopt a plan which is a qualified plan as defined in Section 401 of the Code. The plan qualifies by meeting certain standards to insure its being for the "exclusive benefit of the employees." In order to get the maximum tax advantages, the employer will have to accept certain disadvantages inherent in the statute—coverage of a relatively large group of employees, a permanent program involving in some cases a relatively fixed commitment of funds, and restrictions upon the investment and distribution of the funds accumulated.

The qualified plan may involve creation of a trust meeting the requirements of Section 401 or the employer may purchase retirement annuities. If the plan is qualified, the employer deducts the contribution to the trust or the cost of the retirement annuities when made. The earnings of the trust are tax exempt and the employee pays tax only as the amounts are received and is then taxed, under certain circumstances, at capital gains rates.

The requirements to be met by a pension or profit-sharing trust in order to qualify for tax exemption are as follows:

(1) The trust must be created and maintained in the United States.

(2) The trust must be part of a stock bonus, pension or profit-sharing plan.

(3) The plan must be for the exclusive benefit of the employees or their beneficiaries and it must be impossible to divert the assets of the trust to any other use before satisfying all liabilities to the employees.

(4) Contributions to the trust must be for the purpose of distributing corpus and income to the employees or their beneficiaries.

(5) The contributions or benefits under the plan must not discriminate in favor of officers, shareholders, or highly compensated or supervisory employees.

(6) Certain requirements for coverage must be met.

The test as to coverage can be met in either of two ways. One test is that the plan benefits 70% of all employees (excluding new, part-time and seasonal employees) or 80% of eligible employees if 70% of all employees are eligible.

As an alternative to this test, and the more popular approach to qualification, the plan may be drawn to include any employee group which the Commissioner finds does not discriminate in favor of shareholders, officers, highly compensated or supervisory employees. The plan and the trust can be drawn so that several corporations contribute to it, but the qualifications must be met

by each participant. The plan must be a definite, written program, and communicated to the employees.

A pension plan is designated to provide for the payment of definitely determined benefits over a period of years, usually for life, after retirement. The Commissioner recognizes payment in the manner of variable annuities as meeting the requirements of "definitely determined."

A profit-sharing plan is intended to provide for employee participation in profits after a fixed period of years not necessarily associated with retirement such as disability, death or termination of employment. Most profit-sharing plans are of the retirement type, the principal distinction from pension plans being that the employers' contributions are based upon profits rather than being actuarially determined and the employees' benefits are therefore not definitely predictable.

The profit-sharing plan must include a formula for allocating the contribution and the earnings of the trust to the participants and for distributing the funds to the participants at retirement or at some earlier date due to such contingencies as illness, death, or termination of employment. The regulations no longer require a predetermined formula for determining the amount of profits to be contributed to the trust. The Service still requires, however, recurring and substantial contributions. While prior approval of the Internal Revenue Service is not required, it is certainly desirable. Advance determination letters are now issued by the District Director's Office with appeal to Washington in certain circumstances.

Contributions made to the trust are deductible if the trust is exempt from tax on the last day of the employer's taxable year. A trust may lose its exempt status if it engages in a "prohibited transaction," that is a transaction opposed to its being for the exclusive benefit of the employees. Among such prohibited transactions are the lending of its funds without reasonable security or a reasonable rate of return, paying excessive compensation, or making substantial purchases of securities or other property at more than fair market value or sales at less than fair market value.

Investment by the trust in securities of the employer is not prohibited. The regulations, however, place substantial obstacles in the way of such an investment. Notification of such an investment must be given, either with the annual return, or with a

request for an advance determination. Information which must be submitted includes financial statements of the employer, a schedule of investments of the trust fund and information in respect to the investment in the securities of the employer, such as the present rate of return, the security if a loan is involved and the reason for the investment.

The trust is taxable on unrelated business income as are other exempt organizations. Rental income is also taxable if business lease indebtedness is incurred and is taxed in the ratio of the business lease indebtedness to the adjusted basis of the property.

The regulations make frequent reference to the term "for the exclusive benefit of the employee or his beneficiary." This phrase is applied not only to coverage and investments as noted above, but also to benefits. There must not be discrimination in favor of officers, stockholders or highly compensated employees. The problem of discrimination in profit-sharing plans often arises in drawing up the formula for allocation of benefits. The regulations provide that a formula will not be considered discriminatory merely because it allocates benefits in relationship to total compensation of the participants. If, however, recognition is to be given to service as well as compensation, the problem of discrimination might easily arise because the officers or highly compensated employees are often those with the longest service.

The employer is permitted to integrate his plan with social security benefits so that the plan will not be discriminatory if the benefits received from social security plus the benefits received under the plan bear a uniform relationship to compensation. Allocation of forfeitures because of employees withdrawing from the plan must not result in discrimination. In pension plans the forfeitures must be used to reduce the amount that would otherwise be paid by the employer. The Service must be satisfied not only that the plan is satisfactory in form, but also that it is not discriminatory in its operation.

The law in respect to pension and profit-sharing plans is drawn with the presumption that the employer's plan is permanent. If the plan is discontinued after a few years there is a presumption that the employer did not intend the plan as a permanent program, and in the absence of evidence overcoming this presumption, the plan will be disqualified retroactively. To overcome the presumption the employer must submit evidence that the abandonment of the plan was a case of "business necessity." The rulings, in

their usual style of restating the obvious with great clarity, tell us that bankruptcy is prima facie evidence of a business necessity. Other cases of business necessity will have to depend on the facts.

The tax advantages to the employer of having his plan qualified are two-fold:

(1) Contributions to the qualified plan are deductible when paid.

(2) As the income of the trust is nontaxable when received by the trust, the employer can provide pension with less out-of-pocket costs. One estimate of the benefit of tax-free accumulation of income by the trust places the cost of providing pensions by means of a qualified plan at two-thirds the cost of providing the same pensions by means of a nonqualified plan.

A contribution for retirement purposes is generally deducted only in the year paid whether the taxpayer is on a cash or accrual basis. A contribution to a qualified plan may, however, be deducted by an accrual basis taxpayer if paid not later than the time prescribed for filing the tax return, including extensions granted for such filing. The contribution to a pension plan is generally limited by the actuarial cost of providing the pensions with certain restrictions on the deduction of amounts required to pay for service prior to the establishment of the plan. Deduction for contributions to a profit-sharing plan is limited to 15% of the compensation of covered employees with the provision for carry-over of contributions in excess of the 15% to be deducted in later years. A limitation of 25% of compensation of covered employees is effective where there is both a profit-sharing and pension plan.

As to the tax benefits of the employee covered by a qualified plan, the greatest is of course, that taxation of amounts contributed by the employer is deferred until it is paid or made available to the employee. Lump sum distributions may be taxable as long-term capital gain.

Where the distributions are made over a period of years, the amount included in gross income under the annuity rules is treated as ordinary income. Where contributions to the fund were made only by the employer, this would of course mean that the distributions would be fully taxable.

Where the distributions of a qualified pension or profit-sharing trust are paid to or credited to an employee in one taxable year on account of the employee's death or other separation from service, the income resulting from the distribution is taxed as long-term capital gain. The section is written to accord the long-term capital

gain treatment only to taxpayers terminating their service. Continuation of employment after the scheduled retirement age will therefore result in receipt of ordinary income.

When the lump sum distribution is made to a beneficiary of a deceased employee, the beneficiary will be entitled not only to the capital gain treatment, but also to the death benefit exclusion under Section 101(b) up to a maximum of $5,000.

If the distribution from the trust consists of an annuity contract bought by the exempt trust for the employee, the employee is not required to include the cash value of the policy in income in the year received even though this value would be available to him by surrender of the contract. There is no taxable income until the policy is actually surrendered.

If the employer is unwilling to accept the restrictions upon qualified plans, he may find a solution in some other form of deferred payment plan. Deduction under Section 404 is not limited to qualified pension and profit-sharing plans. Almost any arrangement for payment of pensions, either directly by the employer or indirectly through a trust falls within the scope of the Section.

Under the provisions of Section 404(a)(5), however, any contributions to a nonexempt trusteed plan are deductible when made only if the rights of the employee are nonforfeitable—that is the employee's rights are not contingent on his remaining in employment or any other factors. If the employee has a nonforfeitable right then the employee is taxable in the year the contribution was made, so that no tax advantage has been achieved.

If the employee's rights are forfeitable, then the amount is deductible only in the year that the employee receives payment and the payment is deductible in that year. If the payment is made to a revocable trust the situation is the same as if the employer had made the payment directly. The trust is treated as the agent of the employer. If the payment were made to an irrevocable trust and the employee's rights were forfeitable, then it is doubtful that the employer would receive a deduction in any taxable year.

The simplest form of deferred compensation outside the qualified plans and probably the most satisfactory, is the employer's unsecured promise to pay compensation in a later period than it is earned.

The simplest form of such a contract would be something like the following: "As additional compensation for services to be rendered in 1961, the employer promises to pay $10,000 in annual installments of $1,000 each in the ten years following the 65th birthday of the employee."

The usefulness of the device depends almost entirely on its tax effects. The major objectives are to postpone the tax to the recipient until he receives the deferred payments and to assure a tax deduction to the employer when the payments are made. The 1954 Code does not specifically cover deferred compensation agreements and the tax effect must be determined from several Code sections, the regulations and the cases.

The employer's individual contract for deferred compensation is adaptable to many situations. The tax consequences of the plan are ordinarily plain. The employer claims a tax deduction in the year in which payments are made. The employee includes them in income when received. In event of death the estate or beneficiary includes them in income in the year received.

It is unnecessary to satisfy the confining requirements written into the Statute for qualified plans. The plan can be drawn for one executive without regard to discrimination, coverage, permanency and other requirements of qualified plans. Its flexibility is its great advantage. We can use it alone to provide retirement funds for one or a few executives in a small company or as a supplement to a qualified plan. It can also be used for employees who are of such an age that coverage under a qualified plan is too expensive or not attractive because of the few years of participation.

The plan can defer receipt of the income until retirement to take advantage of the lower tax rates. It can also be used to spread say a bonus for the year 1961 over the five following years, thus keeping the income at a relatively level amount and incidentally conserving the funds of the employer. Or, by making receipt conditional upon continued employment, the employer would secure a strong hold on the services of the employee.

The tax consequences of the deferred payment plan are decidedly inferior to the qualified pension or profit-sharing plan. It cannot achieve the advantage of immediate deduction to the employer and it fails to achieve the most important objectives named earlier—nontaxable income and capital gain treatment to the recipient.

Its only tax benefit is in deferring the tax to a year when the employee will be taxed in a lower bracket. To achieve this objective we must guard against the application of two popular tax doctrines—constructive receipt to the employee when the services which entitle him to the income are rendered and the theory that the contract itself is of economic value and results in tax incidence even in the absence of receipt of cash.

The problem of constructive receipt can ordinarily be effectively answered by the fact that arrangements are entered into before the income is earned. The employee could therefore agree now as to the timing of payment of his 1961 bonus without a problem of constructive receipt. The argument as to economic benefit is usually answered by inserting into the contract various conditions with which the employees must comply to avoid forfeiture of his benefits:

(1) To continue employment to retirement date or some earlier payment date.

(2) To hold himself available for consulting services after retirement.

(3) To refrain from competition with the employer after retirement.

A recent ruling indicates that these conditions relating to forfeiture are unnecessary for tax purposes. So long as the future payments are merely an unsecured contract, a cash basis taxpayer will not be taxable until receipt of benefits. The employer may, however, prefer them as a part of the agreement for nontax reasons—to secure for himself the exclusive services of the employee. Another common provision of such a contract is a prohibition against pledging or transferring the benefits.

The deferred compensation plan cannot be funded by creating a fund in which the employee has an interest either forfeitable or nonforfeitable. If the employee's interest is nonforfeitable then he will be taxed immediately. If a fund is created in which the employee has a forfeitable interest, then the employee will be taxed only when the income is received. The employer will be entitled to no deduction, however, either when payment is made to the fund or when the fund makes payments to the employee. There should be no objection to the employer creating a fund in which the employee has absolutely no interest. This could be accomplished through purchase of an endowment policy in which the employee had no interest or in some other manner. There would, of course, be no tax benefit to the employer from funding and the great objection is the requirement to use cash currently.

The most important advantages and disadvantages of the various methods of providing some form of deferred income or retirement benefits can be summarized as follows:

Profit-Sharing Plan:

Its greatest appeal is the avoidance of fixed commitments. It, however, will not answer the demand for a pension plan among older employees. Divulging the amount of profits will be objectionable to some employers. It may be written to provide supplementary benefits not possible in pension plans—such as layoff benefits, sickness, accident or other hardship. As it is not bound by actuarial computations, there is greater freedom in investments—possibly in employer securities or purchase and leaseback of employer's plant.

Pension Plan:

A pension plan is the only possibility of providing definite retirement benefits that will satisfy the older workers seeking an assured retirement fund. By recognizing past service the pension plan will probably provide the greater benefits to the stockholder-management group than a profit-sharing plan. Like the profit-sharing plan it provides maximum tax benefits.

Deferred Compensation Plan:

Principal benefit is ability to deal with employees on an individual basis without restrictions of qualified plans. Its tax effects are inferior to qualified plans, however, although it does permit deferring tax to low-income years. It is often the only practical plan for the small corporation in dealing with the executive group.

Public Relations

By *T. Roy Grubbs*
A. M. Pullen & Company, Richmond Office

Not having a choice of subjects we are asked to discuss at these partners' meetings, I was glad when Jack Dickinson assigned me the one of Public Relations and the Certified Public Accountant. It is a timely topic and one in which I have always been extremely interested.

But, today I feel like, I am sure, a friend of mine in the tractor and road equipment business felt last summer when he attended a convention of distributors and was asked to speak on the subject of "The Importance of Good Accounting Practices in the Tractor and Road Machinery Business." He invited me to sit in on his speech and he made a good one. He didn't say anything except that each distributor like those present should have a good accounting department or he could lose his shirt. And everybody there knew that. He bragged a bit about his own accounting department—but he really didn't know enough about the subject to explain to his fellow distributors just how it worked.

In the end—he made a most profound statement—and one that pleased me very much. He recommended that if any of the men there wanted to improve their accounting methods, they should call in an expert—A Certified Public Accountant.

Today, I find myself in pretty much the same position—for the field of Public Relations is one for experts—just the same as ours. The main difference that I find in our two positions is that our field seems to be about 99% work and 1% talk; whereas, the field of public relations is about 99% talk and 1% work. Please don't misunderstand me. Their work is important and I am only trying to say that it is a field for specialists. We as accountants should be familiar enough with the public relations field to advise our clients where to seek counsel when there appears to be a need for this specialized service.

There is rapidly building up a large body of practitioners or experts who devote themselves entirely to the art of finding proper ways of communication that will make people think well of the product or service they wish to sell.

The manner in which we should tell the public about our profession and about the various types of services we render has

been the subject of a great deal of study and experiment in recent years. The American Institute of Certified Public Accountants has its Director of Public Relations and a regular standing committee to continuously study problems concerning our relations with the public. And—many of the large accounting firms now have their public relations co-ordinator or director charged with the responsibility of keeping financial and business men acquainted with their firm and the types of services they render, particularly in the newer fields of management services, electronic data processing, and operations research.

Many speeches have been made and magazine articles written by members of the American Institute about this subject of public relations with such titles as "Selling Ideas," "The C.P.A. in His Community," "Opportunity for Service" and "Public Relations and Morality." In this last article the author used quotations from the Bible as being applicable to public relations, such as "Whatsoever a man soweth, that shall he also reap" and "As a man thinketh in his heart, so he is."

Our managing partner, Mr. Perrin, made an excellent talk at the North Carolina Association of C.P.A.s meeting at Chapel Hill in June, 1952, on the subject "Your Community Needs You." He was a member of the Institute's Committee on Public Relations for several years and was its chairman in 1951. One statement he made in his talk is quite significant and I would like to repeat it here. He said:

> "The nature of a public accountant's work and his preoccupation with cold facts, as well as the conservative disposition he develops over the years, often renders him by nature rather inclined to avoid contact with the public. As a result, he may suffer in the public's estimation by comparison with a member of a more articulate profession if he does not study this question of public relations."

Now to a discussion of the subject and what men in our profession can do about it.

What is public relations? I tried to find a definition of the term. There are at least forty, and one was thirty-six words long. So I gave up and decided to use my own definition.

> *Public relations is what it says—our relations with the public.*

And we should always bear in mind that we must first deserve the good will we are seeking and that the public is going to form its own opinion of us, largely from the attitudes, conduct, activities and appearance of the individual members of our profession.

We are not free as individuals to live to ourselves without giving some thought as to the welfare of others in the community.

A certified public accountant's public may be divided into many parts. One of his "publics" is his clients. We will call this client's relations, and it is the most important one. Another speaker will cover this subject, but I would like to say in passing that referrals, or recommendations, of our present clients are the important factors in the growth of our firm, and I believe will account for at least one-half of our new clients.

My talk is therefore to be confined to the "publics" other than present clients, and the first among this group are his prospects or folks he would like to have for his clients. Another "public" might be people that he would never list among those he served but could have lots of influence on his prospects—like bankers, investment brokers and lawyers. And—still another "public" could be those in political life—congressmen, senators and state legislators. Here is a fertile field for a good public relations job, for some of them still think of us as expert bookkeepers.

The truth is, the Certified Public Accountant has many "publics" and our relations with all of them should always reflect the highest possible standards of our great profession.

I realize that few of our prospects walk into our offices. But, what if one should. Does he find a modern office giving an impression of dignified efficiency, with a receptionist who appears to be an intelligent person that can be trusted with the intimate knowledge of an important client's business?

Little things, like the answering of the telephone in a pleasant and efficient manner and the businesslike appearance of our correspondents have a bearing on what the public will think of us. Remember, we have public relations whether we plan to or not—the question is whether we have good ones.

Professional public relations are somewhat restricted in the ways that we must use to get our story over to the public. We cannot advertise in the newspapers or over the radio or television and salesmanship is not a nice word to use in the professions. But, I do believe salesmanship is practiced legitimately in one way or another by all successful professional men. Doctors confronted with unfavorable legislation are constantly selling the public on the value of our present medical system, and lawyers are proficient in the molding of a good public opinion of their profession.

There are many acceptable means which can be employed to help create a favorable public opinion about certified public accountants and their profession. It is up to us to grasp every opportunity to let the public know in the proper manner that the Certified Public Accountant is something more than an accountant, that he is one of the best citizens in his community. Toward this end, I would like to discuss some activities which may prove helpful in our program to improve public opinion.

The expansion of acquaintanceship among business, financial and other professional men should be one of our goals—and what better way can this be accomplished than through memberships in civic, country and city clubs, churches, alumni groups, trade association and chambers of commerce. Whenever there is an opportunity we should accept positions of leadership in such groups.

Benefits can be expected from memberships in organizations only if we take an active part in their affairs and make frequent use of the facilities provided by our city and country clubs. Social or semisocial contacts among business and professional men and their families often lead to worthwhile and devoted friendships.

Memberships in business and trade organizations indicate that we are civic minded, progressive and interested in the general business affairs from a national, state and local standpoint. Here is afforded the chance to meet with the top level business and professional men in dealing with their business and civic problems.

Some of you are members of the Rotary Club and know that the number one object in Rotary is "The development of acquaintance as an opportunity for service." We particularly emphasize acquaintanceship in Rotary and after being an active member for over twenty years, I know that it can be an important factor in our public relations program of making friends with prominent business and professional men in the community. You will note that Rotary emphasizes the development of acquaintances not just the making of them. This is true of any other civic club, country club, or any other organization, if we work at this job of developing friendships. Ample opportunities will be afforded as the friendship grows for mutual discussion of each other's business or professional life, and in this way we may favorably direct impressions as to our vocation and to various services we render. But as Dale Carnegie often said, "it is always well to let the other man do a great deal of the talking."

I have previously stated that some effort should be directed towards rectifying the apparent unfavorable impression that some representatives in governmental bodies have of our profession. At a recent hearing on the bill in our State Legislature, designed to raise educational requirements of persons taking the C.P.A. examination, it was obvious that some legislators were vague as to the dissimilarity between certified public accountants and public bookkeepers.

These representatives belong to the clubs and other organizations we have been talking about and should be included among the friendships we wish to cultivate. This would be a step in the direction of changing any of their adverse opinions about our profession.

There are many different methods used in this development of acquaintances. Some do it on the golf course, some over the bridge table, some by their activities in service clubs and some by working on civic projects. I like to play golf and have found this an excellent way to develop friendships with business men in our community, especially at the 19th hole when there is time to relax and talk. Another way is to invite your new acquaintance to lunch or to your club for dinner along with the wives. You may find your wife an ideal helper in becoming better acquainted. Some folks may say this is nothing but selling, pure and simple, but it is public relations all the same.

A man I consider to be very near the top in the field of public relations told me recently that, "The best way to develop acquaintances is by talking face to face, but that the next best thing to a handshake is a personal letter."

Every time you read of a business acquaintance, even though slight, receiving some promotion or award it is an excellent opportunity to shake hands and offer congratulations or to write a personal congratulatory note. This is good public relations and there are many reasons for writing letters—maybe an anniversary or some honor bestowed upon a friend's son or daughter. I can assure you that such letters will be appreciated and remembered.

We can improve our professional public relations by individually accepting some responsibility to the community by serving on school boards, tax study commissions, advisory and retirement boards and various other civic improvement groups. Our City seeks the services of local certified public accountants in various government activities. At the present time three men

are giving their services to the school board, the retirement pension board, and the tax study commission, and there may be others.

Knowledge of accounting, taxes and practices of different business enterprises with which Certified Public Accountants become familiar through varied experiences makes them well qualified to serve on various public committees and boards. I believe C.P.A.s are aware of their obligations to the community and, when asked, are doing their part along with other professional and business men.

It has been said that the individual C.P.A. who is active in his community is the profession's most potent public relations agent, because he is on the ground where the best public relations are made. This activity should include some volunteer services for the welfare organizations of the community such as the United Fund, Y.M.C.A., Boy Scouts, and various health and social service agencies. Here is an opportunity for meeting and making friends with leading business and professional men of the community.

Some of the National C.P.A. firms have adopted policies that their partners should take part in some activity of local organizations such as the Chamber of Commerce, United Fund, Hospital Boards and others. They have decided that "it's important to get around."

Active participation in the community's affairs must arise from a sincere good will and desire to help others, if it is to be undertaken successfully. People who engage in them solely for personal benefit are easily detected. Also it will be found that abundant personal pleasure, and incidentally business rewards too, will come from the natural and voluntary desire to help in the community welfare. All truly professional people recognize this as their first responsibility.

Much personal satisfaction will be found in serving on church boards and committees where our professional training and business experiences can be helpful in solving their financial problems. A C.P.A. is now Treasurer of our Church and I know many of you are rendering similar valuable services in your communities.

Public speaking can be an important factor in our public relations program. That is, if a good speaker can be provided to talk on an interesting subject and before a group of business and professional men whose good will we are seeking. Talks before trade and local club groups should help to develop our professional reputation and maybe to some degree let the audience know what

we do besides routine auditing. It should be remembered, however, that there can be an adverse public relations effect if the speaker is not endowed with some talent for effective public speaking.

As members of our own professional accounting groups, we have certain responsibilities for the improvement of our professional status by attending meetings, serving on committees and keeping up to date by reading articles on special technical subjects. The preparation of and publication of articles and papers on accounting and tax subjects by our partners or staff members can be an effective agent of public relations for our firm.

After all, what are we trying to achieve by all this work on public relations as it pertains to our profession? And it is hard work not to be regarded as some kind of magic which can perform miracles. As I see it, we are only trying to mold a favorable opinion of our profession, and particularly of our own firm, on all its "publics"—not only on clients, but on legislators, government officials, lawyers, bankers, credit grantors, employees and the general business public. And, secondly, we do want all those persons to know about the various kinds of services we render other than routine accounting, and that there *is* a distinction between accountants and Certified Public Accountants.

What opinion does the business public have about our profession? In an attempt to answer this question the Public Relations Department of the American Institute of Certified Public Accountants has conducted a significant public opinion sampling by interviewing sixty-two (62) business executives in a city located in the New England States and considered to represent a normal community of average size. The survey revealed that—

1. The individual C.P.A.s are highly respected for their technical competence, their personal integrity and their genuine interest in promoting the financial success of their clients—and that they enjoy great prestige for their civic service. Frequent personal and social contacts were of considerable importance in the opinion of clients interviewed.

2. That the Public does not distinguish a Certified Accountant from a noncertified public accountant.

3. That as a group C.P.A.s were considered to be inactive and do not function as a group.

The unfavorable impression as to C.P.A.s as a group was unexpected because about one-fourth of the C.P.A.s in the community were very active in public service and were outstanding

contributors of time and money to the various civic and welfare organizations. Apparently Certified Public Accountants had not stressed the importance of their certificate or received any publicity on their activities as a group. A public relations effort directed towards these impressions should change the thinking of those interviewed.

Some of you may rightfully ask how are we going to find the time from our work to enter into this program of winning friends and influencing people. Well, it does take time and effort, but discreet planning, pinpointed in the right direction, by each of us will, I am sure, produce results in the program of enlightening the business public as to the nature of our services and the eliminating of any unfavorable impressions about our profession. What's good for the profession is good for us, and it is believed that A. M. Pullen & Company will receive the greatest benefit from your efforts.

It has been a pleasure to discuss this subject with you and I thank you for your kind attention.

Client Relations

By *J. S. Kirchheimer*
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How often during the year do you have personal contact with each of your clients? How many letters do you write to him, and how many times do you contact him by telephone? How many times does he visit your office? And how many times do you call on him at his office, or meet him for lunch or dinner?

What I hope I have suggested to you by these questions is a matter that is central to the success of our business or, indeed, of any business—the need for good client relations. This is something that we sometimes take for granted. A form letter transmitting reports, a telephone call or a letter arranging for the audit engagement, or the accountant performing the audit are sometimes our only contacts with our clients. Under conditions like these, aren't we depending a little too heavily on the firm's good name to maintain client satisfaction? Happily for us, I think, most clients have some special problems from time to time which demand a more personal type of attention from our key people. Thus, when something unusual, like a tax case, develops, we see a good deal of him, and a much closer personal relationship is established.

If we, as *professional* accountants, hope to render the maximum service, and thereby realize the maximum benefits for our own organizations, we must assume a larger share in establishing closer personal ties with the management of our client firms. In too many cases, I think we have sought to solve the problem the client presents to us, rather than to help him in fully defining the problem before starting work on the solution. It has been said, with some truth, that 90 per cent of the solution of a problem lies in identifying it—the other 10 per cent is relatively easy. Clients are apt to have rather strong feelings about their problems, and often find it difficult to define them impersonally. Embarking on the solution of a poorly defined problem can be wasteful in terms of time and money; worse still, it can be costly in terms of good will. May I, therefore, suggest to you that we adopt a more client-centered approach, with problem identification as a first objective?

An interesting example of effective problem identification was described to me by a member of the accounting profession a week

or two ago. This man was approached by his client for advice on a tax problem; the client had already formulated his own solution and was really looking for some moral (and possibly professional) support. The accountant's experience in tax matters enabled him to view the problem objectively and it quickly became apparent that the problem might never be settled on the basis the client proposed, and might easily, if the client pressed for settlement on his own terms, end in a costly court battle, with a negative verdict. Even under the most favorable conditions, the chances that the case would go to court were quite high. The client was therefore led, after much discussion, to accept this possibility and to approach the solution of his problem with a little more detachment. He finally came around to the view that his own wishes were quite out of line with reality, and might produce vastly greater headaches than the one suggested by the accountant. His chances for a favorable decision were considerably increased by this change in attitude; actually the change in attitude was really the key to the problem and was only achieved by patient listening on the part of the accountant during the first part of the discussion. When the client had gotten some satisfaction for his personal feelings during the first part of the discussion, he was able to accept an analysis from the accountant based on an objective, but sympathetic, consideration of the real predicament.

Although I don't tell my doctor friends this, I think we are a good deal like the medical profession in our client relations. I don't want to extend my analogy too far, but aren't our clients really our patients in the realm of special business problems. Like the medical patient, the client has lots of problems, not the least of which may be the stress of his business affairs and the extra burdens placed on him when difficult problems arise. He really looks to us to relieve him of part of his load of worries, and we do this best, I think, first by creating a warm, friendly office atmosphere in which he feels free to discuss his problems openly, and second, by putting ourselves into the client's position in our discussion. If he is upset, we don't get upset too, but we do let him know that we appreciate how uncomfortable he feels. This trust-building business is pretty important; if the client knows we are interested in his problem then he will probably be much more receptive to our suggestion that we might help him even more in the future than we have in the past by acquainting him with our full service potential (such as business systems, analysis of the

flow of paper work, and by discovering tax savings he may not have thought possible). Helping our client to understand his needs makes the selling of new services relatively easy.

So this business of satisfying the client comes about not just through our technical competency, but also through our ability to address ourselves to his problem—or problems. This is really a team proposition; our entire organization can make important contributions. But before I get to that, I want to talk about the medical profession again for a moment.

All of you, I'm sure, have a mental picture of the operating room in a hospital, created, no doubt, by television and movie versions of what takes place during an operation. The doctor is in supreme command, isn't he, ordering his assistants around with blunt, crisp commands—"Scalpel!" "Retractor!" "Suture!" This guy is a real sage, he knows what needs doing every moment, and seems to be behaving much like a military commander.

But have you ever visited an operating room? Actually, the scene isn't at all like we find it in the movies. The leadership in the surgical team is pretty difficult to pin down. Conversation is at a minimum; there are no barked orders, and much of what takes place seems to happen almost automatically. If one watches for a while he will discover that leadership in this group shifts around from person to person. These people each have special skills and leadership at a given moment is in the hands of the one on whom the group is most dependent. The anaesthetist tells the surgeon, sometimes by just a nod, when he can begin the operation. As the incisions are made, the surgical assistant occasionally steps into a command position—"Just a minute doctor, let me catch that bleeder." The surgical nurse, watching closely, knows from experience what instrument will be needed next and has it ready. The doctor, pretty much engrossed in what he is doing, says hardly anything at all, and might even appear to the uninitiated to be a flunky. This group is engaged in teamwork of a high order. Really, the ultimate authority in the group is the patient; it is his needs which control every action of the group.

Our accounting organizations are in some ways similar to the surgical team. The first need of our client when he comes to see us is a pleasant, warm reception—this is provided by attractive, but not gaudy, furnishings, and by a receptionist with a pleasing personality. Neither Marilyn Monroe nor Whistler's Mother can do the job very well—somebody about half-way between is more

appropriate. A neat office lends an air of quality and the care we take in the preparation of our reports and the manner in which we present them helps to build confidence in our work. And, if during our discussion, we have planned schedules so that the accountants or some of our specialists are available to participate in the conference when they are needed, he will realize that we've been thinking about his needs and the importance of his time. A set procedure in billing also helps to reinforce this image of careful planning that can never be created by chance.

In another respect, our profession has some common ground with the field of medicine—many of our new clients come to us as referrals. We recently acquired a new client who requires a moderate amount of our services, of the order of $4,000 a year. We had never heard of this man or his firm. He has only recently established a new business in North Carolina, but he was referred to us by one of our well-satisfied clients. We can't advertise, and our satisfied clients are certainly one of our most important assets when it comes to developing new business.

Communication of the results of our work is another area that is important to the development of a solid block of satisfied firms. Business executives are almost as busy as we are, and wherever we can, we should point out to them the important conclusions we have drawn about his operations as a result of our audit. Here we are experts, and the client is sure to be well satisfied with our work if it is not only of high quality, but if we also take the time and trouble to analyze the many reports flowing over our desks and to point out to the executive concerned those matters that we believe deserve his close attention. Sometimes we can sense impending trouble before it occurs, and here a personal word of advice will be especially welcome. Our obligations to the client don't stop with the presentation of purely factual information; he may not take our advice, but we must offer it.

Follow-up on our reports is also of significance. Was our work of maximum usefulness to the client? Are there other things we might have done which would have helped him in arriving at important conclusions. Here, I think we should listen carefully to what the client has to say. The listening increases his awareness that we want to help him with his problems, and we will also get some useful ideas on how we can expand our service to him if we carefully analyze his comments, flattering and otherwise. Naturally, we can't follow up on everything we do, but we can

keep this important function prominent in our thinking. We must, ourselves, decide the priority on follow-ups, and by intelligent choices we can bring back to the firm a great deal of valuable information about our own effectiveness and how to improve it. Follow-up is time consuming—you can't rush a client into either kissing or clobbering you—but it can pay big dividends.

Up to now, I have been talking about matters that relate to our development of good personal relations with our clients. We have certain *obligations*, as professional people, and I have touched on them already. These are:

1. We must point out, before starting work on the client's problem, any significant gaps between what they say they want from us and what we think we should do for them.

2. To tell him, also ahead of time, that a restricted assignment may make it difficult to bring our full capabilities to bear on his problem.

3. To make *specific* recommendations to the client, subject to any client-imposed limitations on our discussion of his problem. (He may not be willing to confide in us completely.)

4. To clearly define for the client any steps he might take with respect to his own internal procedures, or to our services, which would be to his advantage.

It takes a healthy firm to provide the best service and now I want to mention a few things that must not be overlooked or sidestepped, in the development of our maximum effectiveness.

Don't be afraid to charge a fair fee for a job well done. High quality work isn't cheap in any profession, and the worthwhile client expects to pay a fair fee for the best service. There's no doubt that he wants, and deserves, the best service. Let's not unduly restrict ourselves by charging at lower than our actual costs with the hope that we can recoup our losses by maintaining the same billing next year, when we won't need to spend all that extra time on the "preliminaries." The new client knows that he requires a certain amount of extra time, and he knows that our own expenses are fixed. Why then, shouldn't it cost a little more to get started with a new client? We're likely to gain nothing, and may lose a lot, by placing ourselves on the fee tightrope in order to gain new business. The temptation to "buy" new clients can be a mighty strong one, but the chances of developing a durable client relationship on such a basis aren't very good. Clients who seek special deals don't usually turn out to be lasting friends. Clients should pay a fair fee for our services the first year, and for every succeeding year. Our job is to explain our rates in advance

of the engagement, even if the client doesn't bring the matter up. Spending money isn't the most pleasant business for anyone (except our wives), but if we take the initiative in discussing our rates, and are frank and forthright in these matters, we will gain the respect of those who need our services.

As long as the inflationary spiral continues, we will be faced with the necessity of a periodic upward adjustment in our fees. Our clients are caught in this same spiral, and there is no need to feel guilty about an occasional increase. If we neglect to follow the trend, the job becomes doubly hard later. No client is going to propose an increase in our charges; the responsibility here is clearly ours. And in many cases, our personal contacts with clients must be made for the purpose of explaining upward revisions in our rates. We can neither ignore nor avoid the necessity for the tactful discussion of these charges with our clients in face-to-face situations. They will understand our explanations, even if they are not welcome. Let no one assume, however, that we can dodge the issue by simply increasing our billings.

My last point has to do with billings and collection of our fees. Delinquent accounts are a source of some worry in every business, and I suspect that they'll always be with us. The best we can hope to do is to minimize them; delinquent clients are usually quite consistent in their behaviour, and it's probably better to lose some undesirable business than to take it on and live with the headaches of slow collections, year after year. Somebody once said, and I think with a great deal of wisdom, "an empty house is better than a poor tenant." Might our wisest course in our relations with slow-paying clients not be to accept small losses, with early severance of our relations, rather than to prolong an increasingly uncomfortable relationship with the chance for even larger losses in the long run. Some of our better clients will occasionally need some time to settle their accounts—this we understand—but clients that are slow paying this year were generally slow paying last year, too.

In closing, may I reiterate my main theme. Our business, however cold the figures and statistics may seem, is built on personal service. That business which is most successful will surely be built on the recognition and promotion of closer personal ties with its clients, wherever, whenever, and however they can be cultivated.

Procedure in Handling Proposed Additional Federal Income Tax Assessments

By *W. A. Kluttz*
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1. Negotiations Prior to 30-day Letter

(*a*) *Negotiations with Agent*

In your negotiations with the agent, you should be well prepared on the facts, for in many types of issues, here is the best opportunity you will have to get certain issues out of the way, if not all.

As to doubtful items, it is possible that you may be able to agree with the agent on some and get him to agree to others and thus arrive at an equitable basis of settlement of the entire case. If not, you may be able to enter into a partial agreement.

(*b*) *Negotiations with Group Supervisor*

In the event you have been unable to settle with the agent, you may request a conference with the Group Supervisor if a request is made within ten days after the agent has furnished a list of his proposed adjustments.

At this conference, you will be required to submit a power of attorney authorizing you to represent the taxpayer, unless he is with you. It is advisable to have it then or get it forthwith, so that the I.R.S. will contact you, and send you copies of any correspondence.

It is also necessary that you be able, at this level, to show that you have been enrolled to practice before the Treasury Department, or that you have filed application therefor.

The Group Supervisor Conference procedure was set up as a part of the Reorganization Plan in 1952 when the Conference Group in the office of the Internal Revenue Agent in charge was abolished.

It has had a trial run and has proven unsatisfactory in many cases.

Several months ago, the Commissioner set up a modified informal conference procedure for test purposes in the Director's

office for the Chicago District. It is now in effect in certain other districts.

This procedure allows the Conference Coordinator, in certain complex cases, to assign a conferee to the case who was not the Agent's Group Supervisor.

2. Protest

(*a*) *Cases in Which Protest Should Be Filed*

You should realize that there is no statutory provision requiring the Commissioner to send a 30-day letter and grant you the privilege of a protest and conference prior to the issuance of a statutory notice. This is a matter of administrative grace and if you expect to obtain the benefits of the procedure outlined by the Commissioner, you are expected to comply with it.

There may be cases in which you do not desire to file a protest prior to the issuance of a statutory notice. In that event, you should notify the Director and request the issuance of a statutory notice. Further, in the event you desire to file a protest, you should so advise the Director within the 30 days granted or a statutory notice will be issued.

You should forego a protest and the conference procedure prior to the issuance of a statutory notice, in those cases where it is obvious that nothing could be gained, or where the risk of damage from the reopening of issues settled at the agent or informal conference level exceeds the likely benefits from Appellate Division consideration.

(*b*) *Form*

First, it should be in the form outlined by the instructions issued by the Treasury. I am not going into details as to the form at this time, except to mention it in passing.

It should be addressed to the District Director of Internal Revenue and refer to the letter advising of the proposed adjustments by symbols and date. It should state the name and address of the taxpayer, the years involved, the amount of the tax in controversy, a statement of the issues, a statement of the facts upon which you rely to support each, and your argument, including a citation of the law, regulations and decisions.

If you desire a conference, a request therefor should be made in the protest. The protest of course should be verified by the taxpayer.

Statement of Agent or Attorney:

If the protest was prepared by you as attorney or agent, it should contain a statement over your signature to that effect and whether you know of your own knowledge that the facts therein are true.

(*c*) *Contents*

The contents of a protest should be such that the facts, law and argument justify the claim you make to the fullest extent possible. In other words, the protest should be complete. Your protest is the basic document in all proceedings before the Treasury and should contain not merely a full statement of the facts, argument and decisions relied on, but the evidence as well.

(*d*) *Arrangement of Contents*

(*1*) *Issues*

The issues to be protested should be stated first and identified by number, for reference throughout the protest, in the order they will be discussed. Each issue should be stated fully to give the reader a clear picture of what you are about to discuss.

(*2*) *Statement of Facts*

The first paragraph of each statement of facts, stated in the same order as the issues, should contain reference to the agent's adjustment to the return. While it is a matter of personal preference, the author believes that it is more effective to state the facts in respect to each issue before beginning your argument. Some prefer to state the facts of a particular issue followed by the argument on that issue or to mix the two. But you want the reader to get the facts. When he has read the facts, he may decide he knows the answers and that the protest is too long to labor through. In stating the facts, care should be exercised not to burden the reading matter with a lengthy statement of figures or quotations from documents, etc. It is preferable to set these up in an exhibit and refer to it briefly as to what it shows. To a certain extent, brevity is desirable in a protest.

(*3*) *Law and Argument*

The first statement under the heading "Law and Argument," as each issue is taken up for discussion, should be the taxpayer's

contentions. Following this should be the citation of the law and regulations relied upon, your argument and citation of decisions. Note whether the Commissioner has acquiesced in any Tax Court decisions cited.

The Commissioner does not make a regular practice of announcing acquiescence in any decisions except those of the Tax Court. It may be clear that he is not following certain circuit court decisions for the reason he does not agree and is looking for a case to try in another circuit in the hope that he can obtain a conflict in the circuits and thereby obtain a writ of certiorari to the Supreme Court. Your case might be the one he is looking for.

There may be an announcement by the Commissioner that no appeal will be filed in a named case. This is not equivalent to an acquiescence. The reason for nonappeal may be that the Commissioner is looking for a more favorable factual situation to try the issue again; or he may be waiting for a similar issue to arise in a different circuit or he may not consider the issue of sufficient general application to warrant an appeal.

I have observed over the past years that a great many agents and some conferees have the idea that they may not follow any decision as competent authority unless it is published or referred to favorably in the Internal Revenue Bulletin. There is a statement that gives that impression in the introductory matter in the Bulletin, but it is not observed literally in practice.

(*4*) *Conclusion*

At the end of the law and argument on each issue there should be a short paragraph in which you state your conclusion as to the adjustment requested.

It is a good practice at the close of the protest to give a brief summary of the principal facts upon which you rely in respect to each issue. Number the paragraphs to correspond with the numbers of the issues, facts and argument. This will serve two purposes—a quick review for the reader and for your use in your discussions with the Bureau representatives.

Here is a further suggestion that may be helpful. The Appellate Division writes a memorandum sometimes longer than your protest and they are required to state the issue, findings of fact, law and argument and conclusion in that order. The first paragraph of the findings of fact is required to contain the agent's adjustment to the return. The first paragraph of the law and argument is

required to contain the taxpayer's contentions, the last paragraph the conclusion and the adjustments that should be made.

A reviewer looks at these things first to get a bird's-eye view of the problem. If he knows the law applicable he may reach his conclusion before reading the entire memorandum.

You would be surprised how many times a conferee will adopt the wording of your protest if it is sound. That you would like. A little care can be very helpful, not only to the conferee, but to you.

(*e*) *Where a Protest May Be Filed*

A protest may be filed not only with the Director, but if a statutory notice has been issued without the filing of a protest, you still have an opportunity to file a protest after the petition to the Tax Court has been filed and it is very desirable to do so. This protest should be filed with the Appellate Division.

(*f*) *Reasons for a Complete Protest*

There are many reasons why it is important to have your protest complete at the outset. Some of them are:

(1) You want your protest to make a favorable impression not only on the person who first reviews it, but on his reviewer, particularly if a recommendation should be made against acceptance.

(2) If your protest is incomplete or inadequate, in that it does not make out a *prima facie* case, you may lose your right to a hearing before the Appellate Division, prior to the issuance of a statutory notice.

(3) One of the important changes in the Appellate procedure under the Reorganization Plan No. 1 is that unless a protest is filed, the Appellate Division will not consider the case until after the petition is filed to the Tax Court.

(4) A complete protest will serve as an added asset in the stipulation of facts in the event your case comes to trial. The trial counsel is very willing to stipulate any facts that can be verified. If the facts are stated in the protest, they would have been verified by the agent in most cases prior to the time of trial.

(5) Under the reorganization plan, any new issue or new evidence not in the protest will not be considered by the Appellate Division prior to the issuance of the statutory notice.

(6) If it should become necessary in the course of the consideration of your case to forward it to the Regional Commissioner or to the National Office for any reason, such as the consideration of engineering features or for a special ruling, the protest will speak for itself.

(7) Evidence that is submitted piecemeal, part in the protest and part from time to time thereafter, may be ineffective at the crucial moment. The conferee to whom you submit it, can be expected to examine it, but the Head of Division or other official reviewing the case, after the conferee, will seldom look for more than what the agent has to say, what the conferee or Technical Advisor has to say and what the protest has to say. If he stumbled across evidence submitted intermittently, you are lucky. It might mean the difference between a favorable decision and one against you.

(8) A protest may serve as an informal claim for refund. There have been many informal claim cases decided on the question of whether certain documents, letters or protests filed within the Statute of Limitations were informal claims that could be perfected after the Statute had expired by filing a claim on Form 843. Some have been against the taxpayer and some in favor of him. Generally speaking, an issue raised in a protest sworn to by the taxpayer, where a present right exists for the claim, will be sufficient to justify an informal claim which can be later perfected by filing a formal claim. If no protest is filed at the first opportunity, this right may be lost. However, you should never rely on an informal claim in a protest when it is possible to file a timely formal claim on Form 843.

As stated above, the cases in which there is justification for the failure to file a protest are extremely limited.

3. Prosecution of a Protest

(*a*) *Conferences*

Your protest should always request a conference.

Prior to the reorganization, you had the privilege of a conference in the agent's office after filing your protest, but under present procedure your conference ordinarily will be with the Appellate Division, although some consideration is generally given to the protest in the District Director's office before the case is forwarded to the Appellate Division. If settlement is not reached with the Appellate Division prior to the issuance of the statutory notice, you will have an opportunity for a further conference with that Division after you file a petition to the Tax Court.

(*b*) *Other Remedies*

(1) There may be times when the conferee is in doubt and not being willing to shoulder the responsibility himself of allowing the issue, he may welcome your suggestion that the case be referred to Division Counsel for an opinion or to the Engineering Division of the National Office should it be an issue coming within their jurisdiction. There are other issues which deserve the consideration of the National Office experts. Such issues may involve reorganizations, pension trusts, profit-sharing plans, policy question, etc.

This procedure has the approval of the Commissioner as outlined in Rev. Proc. 58–14, C. B. 1958–2, p. 1125.

The Bureau is just as anxious as you are to get the right answer in a case, notwithstanding any experience you may have had. It is for you to decide whether you have had that kind of service, and what your recourse is, short of trial.

(2) Request that case be held in abeyance pending the outcome of a related case or cases in litigation, or pending legislation on the subject matter involved.

(3) If the tax has been assessed, it may be in order to file an offer in compromise. However, beware of compromise agreements which foreclose the taxpayer from the benefits of possible loss carry-backs from later years.

(4) It may be preferable to have the taxpayer pay the tax, file a claim for refund and sue in the District Court or the Court of Claims. The principal difference in procedure between these courts and the Tax Court is that it is now necessary to pay the tax (all of it) to sue in the District Court. If a petition is filed in the Tax Court, it is unnecessary to pay the tax until after a decision by that Court. It may be that the District Court or the Court of Claims would be more favorable because of similar cases already decided or because of the right of a jury trial in the district court. In other cases, the Tax Court might be more favorable. The client should consult with his attorney before reaching any decision to sue.

(5) If at the time you are contemplating an offer in settlement, you should have a carry-back loss for a later year, file your Form 1139 claim for carry-back no later than the time the offer is made and request that they be considered simultaneously, thereby permitting the taxpayer to settle by the payment of a net deficiency or acceptance of a net overpayment, as the case may be.

4. Petition to the Tax Court

(a) In the event you are unable to reach a settlement prior to the issuance of a statutory notice, and you decide to appeal to the Tax Court, a petition should be filed with the Clerk within 90 days from the date of issuance of the statutory notice. Keep in mind that this period is statutory and cannot be extended.

I will not go into the form of a petition. That is outlined in the Rules of Practice before the Tax Court.

Suffice it to say that the petition should contain allegations of error, allegations of fact and prayer for relief. It should contain no argument or conclusions. This is left for your brief.

(b) You will be granted a further conference before the Appellate Division after the petition has been answered by the Commissioner.

(c) In the event settlement has not been reached a pretrial conference will be granted with a representative from the Appellate Division and the

trial attorney from the Regional Counsel's office. At this time a proposed stipulation of facts will be considered, as well as the possibility of settlement.

(d) In the event no agreement is reached at said conference a further conference may be had upon request, after calendar call, with Regional Counsel's office who alone would then have complete jurisdiction.

(e) If you desire (and have adequate grounds for requesting) a continuance of the trial date, a motion therefor should be made not later than at calendar call.

5. Employment of an Attorney to Try the Case

Once it is apparent that it will be necessary to try the case, the client should be so advised. The client generally selects his own counsel.

Encouraging Maximum Achievement by Staff Personnel

By *Charles H. Koller*
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If we are to consider achievement, we must first consider motivation. Only by knowing the elements of motivation can we direct our encouragement of achievement into the proper channels.

The human race likes to flatter itself by describing its behavior as rational. We often see the suggestion that the chief difference between animals and man is that the former are governed by hunger, thirst, sex, fear, anger, and similar psychological and low-order drives, while man can inhibit himself from immediate and direct expression of these. Man is said to possess the unique qualities of looking ahead, planning for the sake of the future, cooperating with others, feeling sympathy, and engaging in abstract thought.

We are now realizing more the importance of the nonrational, the emotional, and the motivational in human behavior. We do not do most things because we *will to* but because we *want to* or *have to*. We can do as we please, but we cannot please as we please.

It is fairly safe to say that there is no behavior without motivation of some sort. Some may be in response to physical needs; some may be done somewhat begrudgingly to avoid conflict with others; and some may be carried on over a long period of time to satisfy a burning ambition. In all cases, there is a goal in sight.

We must recognize some driving force that causes behavior which shows persistence in overcoming obstacles, variability, continued activity until the goal is attained, and then causes relaxation so that further stimulation is ineffective.

Experiments by Tolman, Honzik, Blodgett, Elliott, Bruce, and others clearly show that reward of incentive is obviously the motivating force underlying the learning or performance process.

There are lessons to be learned from these experiments as they relate to motivation:

First: Better work is done if there is a definite goal or reward to be attained.

Second: The performance is enhanced if the reward is appropriate to the needs and desires of the individual.

Third: The greater the desire, the more persistent and powerful will be the effort put forth.

Fourth: If the goal is lost or inappropriate, the work will be done indifferently.

I acknowledge that human behavior is more subtle than this, but there is motivation behind each act. Emotions are stronger than strictly rational and voluntary behavior. Pleasure is usually only suppressed for ordinary routine work if the ultimate satisfaction of the work provides a greater incentive than the distraction of the immediate but more temporary pleasure.

If we wish to apply these principles to our staff member, we must realize that he is subject to pleasures, discomfort, likes and dislikes; he is not a machine. We must ascertain very carefully the exact motives which appeal to him, the merits of various methods of pay, what type supervision brings best results, what type of position is desired apart from the financial return involved, what incentives will bring out his best production, and what treatment best keeps up his morale.

Whiting Williams lists five pertinent observations of motivation:

First: The astonishing consequences—psychological, intellectual, emotional and spiritual—of the worker's financial position (or condition, if you choose).

Second: The surprising vastness of the gap between workers who hold a "prestige" job vs. those who hold an "ordinary" one and vs. those who hold no job at all.

Third: The amazing ignorance, on the part of the employer and of the employee, of each other's deeper purposes and desires and the incredible ease and certainty with which each of these groups proceeds to justify to itself its own viewpoint regarding the other.

Fourth: The unbelievable importance of the worker's feelings and experiences rather than his logic or reason as a factor in *all* his viewpoints and attitudes.

Fifth: The unity of life and labor—the complete impossibility of separating the office from the home.

Williams continues with the observation that the prime motivations of the average worker are: to preserve his self-respect; to be able to express himself with a high degree of accomplishment; to be assured of opportunity to advance. Pay is important but not to the degree commonly assumed. The worker likes to feel that he is indispensable—has power—does big things—has responsibility and importance—and that he makes a contribution and has personal recognition.

So much, for the present, for motivation.

I wonder if, when we speak of motivation and achievement, we are not really speaking of personnel policy.

Personnel policy is a broad field; it encompasses, actually, the entire relationship between a staff accountant and his firm. Thus it might be well to question ourselves a little about our personnel policy.

First—not facetiously—do we have a policy? Does it encompass our ethical and social goals? Do we let our staff know that we require high standards—high standards of admission and high standards of performance? Are we careful to let them know what our standards are? Do we constantly make plain to them that *the best* is the only standard that is acceptable when applied to the services rendered by us?

Do we delegate authority as far down the line as is possible, giving our senior staff men a sense of responsibility not only as it may concern the discharge of an engagement but also as it concerns the training and development of younger staff accountants who are under their direction?

Do we review, regularly, the performance, goals, ideals, interests, problems and ideas of our staff—with them, constructively?

Here is a quick check—not comprehensive—of questions that pertain to personnel policy.

Does the firm make it possible for the ambitious, talented individual to progress as far and as fast as he can?

Is each individual's progress reviewed with him regularly?

Is the firm interested in "career" accountants—men who will fill a place of responsibility on the staff although they know that they have a ceiling beyond which they cannot go?

Do we make known the fact that all promotions are from within the firm, so far as there are qualified men, and that only when a vacancy cannot be filled from within is someone from "outside" brought in?

Is it known that promotion and advancement are based on merit alone and that any qualified staff member can advance, regardless of how irreplaceable he may be in his present assignments?

As regards compensation and "security," do we have a known policy regarding compensation—retirement—separation, either voluntary or involuntary?

Do we have known policies regarding hours and travel? Are working conditions good—fair—adequate—or something less than desirable?

Do we recognize "status" by pay only, or do we also allot titles?

Do we—the partners—fail to let the staff know the importance of a new assignment because *we* know it and *think* they should too?

Do we let the staff know that we consider development to result from training and that we provide this essential in the progress of our professional man—that mistakes are tolerated for the first time, although not for the second or third times?

Do we expose our staff men to as many different problems and complex situations as possible and give them as much responsibility in dealing with clients as their experience allows? Do we train them at an early time that constructive criticism and suggestion are of prime value to a client, particularly as they result from an audit engagement and a review of internal control and procedures?

The answers to these questions are important—important to the firm and important to the staff.

Encouraging maximum achievement by staff personnel is then a blending of the theoretical concepts underlying motivation and their application—at least in part—by personnel policies. This is a development process and, as such, is much broader in scope than a mere training program. Development includes the responsibility for personality, dress and appearance, technical training, compensation, job classification and titles, professional growth and understanding, and, also, the satisfaction or fulfillment of urges, desires and ambitions of the staff member, since we have recognized that these form a significant part of the motivation of each individual.

When we consider the rapid growth in the number of C.P.A.s in this country and the increasingly important role of the C.P.A., it is apparent that a very creditable job has been done in training new men in the skills of our profession. It is a truly astonishing record in view of the fact that this growth has been accompanied by steadily rising standards of conduct and performance; and yet, most practitioners want more skilled men and wish to improve the processes of instruction, development and achievement. This continuing search for better ways to disseminate the skills of public accounting is a healthy sign; it augurs well for the future.

Although each man entering the profession has prime responsibility for his own development, the employing firm can and should help by means of a well-rounded training and development program.

The principals in charge of an accounting office, be it large or small, play a most important part in setting the stage for staff training and development and in encouraging maximum achievement from staff personnel. Wise indeed is the practitioner who gives his staff constant reminders, by words and deed, that he considers training, development and achievement important, and who, when evaluating the performance of men, gives due regard and recognition to their ability to train assistants. Under the impetus of such example, staff members down the line will be prompted to take more constructive action than they otherwise would.

Reminding staff members periodically that one of the factors on which they are rated is their ability to train assistants has a salutary effect on the way they carry out on-the-job staff training. It is also desirable to inform staff members of the other factors on which they are rated, including special emphasis on achievement. A consciousness of achievement, once firmly established in the senior staff members, is contagious.

Specific information on ratings—that is, on what is important in the eyes of the firm—assists the staff member by giving him direction in his self-improvement efforts. When an office has a formal personnel reporting system, this may be done by giving each staff member a copy of the report and discussing it with him. When an office does not require a formal personnel report, there should be prepared for the information of the staff a list of personal and technical qualities which will influence their progress.

By way of illustration, and without intending to imply completeness, I suggest the following qualifications should be considered in appraising and counseling staff members:

Important personal qualifications include integrity; loyalty; reliability; cooperativeness; receptiveness to criticism; conduct; neatness of appearance; and the ability to work with and gain the respect of others.

Technical qualifications which are indicative of a man's professional skill include knowledge of accounting principles and procedures; auditing aptitude and imagination; analytical ability; judgment; ability to grasp and adhere to instructions; accuracy; efficiency in performing assigned tasks; neatness and legibility of work; completeness and content of audit work papers; and last, but by no means least, competence in self-expression as shown by explanations and instructions given to assistants, discussions with

clients, written memoranda and letters, and, finally, style, grammar and clarity in report writing.

Administrative qualifications include the ability to plan and organize work; the ability to direct and train assistants; acceptance of responsibility; and the ability to complete work with a minimum of supervision. You will note that I am dealing only with the administrative qualifications necessary for a well-qualified staff man—not necessarily those required of an administrator of an office.

Staff assistants receive the most effective training while on work assignments; this applies not only to new assistants but equally to accountants at all levels of responsibility. Many of the most important and fundamental staff training procedures should be an integral part of good job administration. These procedures apply with equal force to the principal in his dealings with all of the accountants on his jobs, to the senior dealing with his assistants; and to the semisenior in his work with juniors.

Small things can often be invaluable in the training, development, and potential achievement of a staff member. One which comes to mind immediately is proper briefing.

If a staff member is advised in time of his next assignment, he will, with very little prompting, before the field work is started, study last year's report and work papers and seek out published information on the industry and its special accounting and auditing problems. In addition to this, the principal should take time to explain the salient features of the client's business, financial statements, accounting records and procedures, system of internal control, and any unusual accounting or auditing problems expected to be encountered. Also, whenever it may be applicable, the scope and purpose of the examination should be explained; it may, in some cases, even be desirable to review each step of the proposed work program, explaining the meaning and purpose of each step and its relationship to the over-all scope and purpose.

Finally, some indication of time requirements should be given. I do not feel that a proper examination can be limited by a strict time budget; however, a reasonable estimate of the time required under normal circumstances to complete the various phases of an engagement can be made, and the man assigned to the work should be made aware of the estimated time to complete.

One more topic requires mention in the over-all framework of my subject—communication.

In the case of a small firm or office, management does not have the problem of "selling" ideas and attitudes to the staff. The principal knows each staff man intimately—often even the staff families. He is thoroughly familiar with each man's abilities and shortcomings; and, conversely, the staff knows a great deal about the principal, including his policies and methods.

When a company begins to grow, maintaining personal contact between principal and staff becomes increasingly difficult and, eventually, almost impossible. The company is confronted with the problem of what to do to retain or recapture the "one big family" spirit. Since public accounting is unique, in that staff men are assigned to widely separated jobs, and their contacts with each other and with the principals of the firm are fewer than in industry, the need for unity in a C.P.A. firm with a staff of 20 men might be as important and as difficult as in a corporation with several hundred employees.

Communication can be maintained in many ways. One of the first that comes to mind is the staff meeting. A well-organized staff meeting can accomplish many things; a sense of unity is developed by the mere physical presence of all the staff and principals together. Critiques of work produced by staff men (not named, of course) can be important to the work of all staff men. Instructive discussions of current auditing and tax matters have educational value.

In such a meeting, problems of the firm, as well as its accomplishments, and problems of the staff and the accomplishment of its several members can be aired fruitfully and beneficially for all concerned.

However, as we all know, staff meetings are not easily arranged for a large staff. There are conflicting engagements or inability for various reasons for some members to attend. As the firm grows, staff meetings become less and less feasible.

A second solution relies on a "staff memorandum"—a bulletin containing various directives and/or observations which the staff should note. Although the staff memorandum has the desired circulation within the firm, it lacks the communicative response that can be obtained from questions and answers during a staff meeting. Regardless of its shortcomings, the memorandum is an effective way for the firm to communicate with the staff. It does not, however, serve the purpose of letting the staff communicate with the principals.

The employer house organ, or company newspaper, is a partial answer to the problem of communication. Such a publication comes closer than almost anything else to developing and controlling personal contact and getting across the management message to the staff. The success of this venture depends on whether the paper is read, understood and believed by its readers. In order to be effective, it is necessary to devote the major portion of the space to news about the employees and their doings and to take pains to humanize the employer. Some space should always be allotted to company policy and some to new developments in the profession.

The house organ gives the staff a sense of belonging, of being associated with an organization of which they can be proud. By putting facts before the employees, it allays suspicion and doubt and answers questions which might, if unanswered, grow far beyond their proper proportion. It is a method of communication to inform the employees of company rules, policies, and objectives.

Do not misunderstand me. These are not the be all—end all of communication; these are only several of many means. In the final analysis, there is, in my opinion, no adequate substitute for the personal interview, the firsthand contact between staff and principal. The other means are intended to supplement this relationship, not to substitute for it.

At all times there must be an open door and an understanding principal behind it—available for counsel and advice and willing to give freely and sympathetically of his time, experience and knowledge to any staff member who feels in need of guidance, personal or professional.

No avenue of communication between management and staff or between staff and management may ever be closed if maximum achievement on the part of staff personnel is to be effected.

If we are to encourage maximum achievement by staff personnel, we must first realize that motivation is the keystone of our problem. Motivation is, in most cases, largely nonrational. Reward and prestige are important—reward must be appropriate. Financial condition, present and future, has a tremendous effect, but so also do recognition, self respect, sense of accomplishment, power, and sense of responsibility.

In order that motivation may be properly channelled, we must have an adequate, comprehensive personnel policy—one that

has been published to the staff and is clear to them—one that is designed to direct their motivation toward maximum achievement.

Given, then, motivation and direction, we next must consider development. Development must start with the staff member but should be cultivated by the firm. Goals must be set in the realms of personality traits, professional skills, and administrative qualifications. The staff must be advised what these goals are, counseled as to their progress in attaining them, and assisted and advised in their efforts toward self-improvement.

Finally, all avenues of communication, in the most comprehensive sense, must be kept open at all times.

Thus, a properly motivated staff member, working within a known framework of personnel policy, with opportunity for development and adequate communication, will have all of the encouragement we can give him toward maximum achievement.

Taxation of Interstate Operations

By *E. A. Shivers*
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On February 24, last year, the Supreme Court of the United States tossed a bombshell into the lap of business. This bombshell consisted of an entirely new concept of the powers of states to tax income derived from interstate operations. In the court's opinion rendered in the cases of *Northwestern States Portland Cement Company* v. *State of Minnesota* and *T. V. Williams*, as *State Revenue Commissioner* v. *Stockham Valves and Fittings, Inc.*, it held ". . . that net income from the interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing state forming sufficient nexus to support the same." These two cases presented the same question, and the facts in each were very similar. The question was, could states tax income earned in purely interstate commerce.

Here is a brief summary of the facts: The Northwestern States Portland Cement Company is an Iowa Corporation with its plant and home office in Mason City, Iowa. Northwestern maintained a rented office in Minneapolis, Minnesota, with a staff of two salesmen and a secretary. It did not maintain a stock of goods in Minnesota, owned no real estate, and had no bank accounts in the state. The salesmen regularly and systematically solicited orders from a restricted list of buyers. Each order was forwarded to the home office for acceptance, and deliveries were made by shipment of goods from Iowa.

Stockham is a Delaware Corporation with its plant and principal office in Birmingham, Alabama. It maintained an office in Atlanta, Georgia, staffed by a salesman and a secretary. It did not maintain a stock of goods in Georgia, owned no real estate, and had no bank accounts in the state. The salesman solicited orders in Georgia, and certain other states. Each order was forwarded to the home office for acceptance, and deliveries were made by shipment of goods from Alabama.

The Supreme Court's decision did not specify a method of apportionment, nor the kind or extent of activities performed within the foreign state necessary to meet the "sufficient nexus" requirement.

In upholding the taxes levied by Minnesota and Georgia, the two states involved here, the court cited a number of cases as precedents. However, Justices Whittaker, Frankfurter and Stewart filed dissenting opinions in which they stated that the cases cited as precedents by the majority actually pointed in the opposite direction. Justice Frankfurter filed a separate dissenting opinion in which he said, ". . . today's decision cannot rest on the basis of adjudicated precedents. . . . The history of the Commerce Clause is the history of judicial evolution. It is one thing, however, to recognize the taxing power of the States in relation to purely interstate activities and quite another thing to say that that power has already been established by the decisions of this Court. If new ground is to be broken, the ground must be justified and not treated as though it were old ground." These dissenting opinions are mentioned to point out that one-third of the members of this Court recognized the majority decision as entirely new, although it is the position maintained by some state taxing authorities for many years.

The Northwestern-Stockham decision caused considerable consternation among businessmen. They visualized liability for back taxes in states where they had not filed returns and considerable expense in assembling the information necessary to file these returns. A large number of businessmen asked Congress to enact a law which would specify the amount of business activity in which they might engage within a foreign state without becoming liable for that state's tax on income. The Senate Small Business Committee held hearings on this subject in Boston, New York, Newark and Washington. State taxing authorities as well as business were represented. At the conclusion of the hearings the Committee recognized state taxation as becoming a burden on a great many small businesses that operate in interstate commerce, and that in many cases the cost of preparing and filing tax returns would exceed the amount of tax involved. As a result of the findings of this Committee, Congress enacted Public Law 86–272 which undertakes to limit the power of states in this respect. Unfortunately the law takes a negative approach to the problem. However, it appears to cut off the power of states at the line drawn by the Northwestern-Stockham decision.

Following is an excerpt from the law:

"Sec. 101. (a) No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of

this Act, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(c) For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property."

This law provides that a state may tax its own citizens and residents and corporations incorporated under its laws without regard to the limitation quoted. The act goes on to define "independent contractor" as a broker, or commission agent, who acts for more than one principal and holds himself out to be such as his regular business, and it points out that "representative" does not include an independent contractor. The act contains provisions to prevent retroactive assessment of taxes, but allows collection of taxes already assessed. Congress recognized this law as a stopgap measure and ordered the Committee on the Judiciary of the House and the Committee on Finance of the Senate, acting separately or jointly, to make a complete and full study of all matters pertaining to taxation by the States on income derived within the states from the conduct of business in interstate commerce and to propose legislation providing uniform standards to be observed by the states. The Committees are to submit their reports on or before July 1, 1962.

The law, as it now stands, indicates that if a person is engaged in interstate commerce and his activities in a foreign state consist of no more than mere solicitation of orders, by himself or his representative, he is immune from assessment of state income taxes on the income derived from such orders. The immunity will be

lost if he maintains an office in the foreign state. Of course, other business activities within the foreign state will result in loss of immunity. This new law does not question the Supreme Court's decision in Northwestern-Stockham, and as it now stands, it attempts to hold the line, but in doing so leaves a broad area of uncertainty and doubt. The law most likely will be amended; it even may be repealed. If it is repealed, it is to be hoped a better law will be enacted to take its place. We probably will be called upon to prepare returns and therefore we should know as much as possible about the new law. It is probable that this problem of taxation will remain unsettled for a number of years. It certainly will not be settled before the Committees submit their reports in 1962 and after that any laws, or changes in the present law resulting from their reports, may have to be interpreted by the U. S. Supreme Court. The law now limits itself to the sale of tangible personal property. In due course, additional laws may be enacted relating to banks, insurance companies, public utilities, transportation, and other businesses not related to the sale of tangible personal property.

You will recall that the Northwestern-Stockham decision provided that the levy be properly apportioned. The two states involved in the case use for the purpose of apportionment, a formula containing three factors. These formulas are not identical but basically they consist of the ratio of receipts, payroll and property within state to the taxpayer's total receipts, payroll and property. Not all of the states that levy a tax measured by income use this formula. The formulas and the factors in the formulas vary to such an extent that there is a complete lack of uniformity. Some states use sales and others receipts. Some states use inventory and others use all tangible property and some include rented property. When rented property is included it is valued at a multiple of the annual rent. Some states use property valued at the end of the year, while others use average values. Some states use total payroll and others use payroll, excluding pay of executive officers. In addition to those three factors, other factors are used or included. Among them are, cost of manufacturing, cost of sales, cost of operations, purchases, and others. The manner in which these formulas are constructed is such that they could result in some taxpayers paying tax on more than 100% of net income. Arriving at a solution to this problem is going to be very difficult. The National Conference of Commissioners on Uniform State Laws

has offered a solution in the form of a proposed uniform act which has gained some approval. This proposed act consists of a method of allocation and a formula for apportionment. The recommendation for legislation to be proposed by the Senate and House Committees may offer a similar solution. The proposed uniform act provides that:

1. Taxable business income is income from sources connected with the taxpayer's regular trade or business.

2. Rents, interest, dividends and other intangible income derived from sources connected with the taxpayer's regular trade or business is to be apportioned, while such income derived from investment capital not used in taxpayer's regular business is to be allocated to the situs of the property or to the executive office if the property has no situs.

3. Taxable business income is apportioned among the states on the basis of a three-factor-formula consisting of property, payroll, and sales.

a. The property factor is a fraction, of which the numerator is the average value of all real and tangible property owned or rented and used in the state during the tax period; and the denominator is the average of all real and tangible property owned or rented and used everywhere.

b. The payroll factor includes all compensation and attaches to the place where the employees' activities occur.

c. In the sales factor, sales are assigned to the state in which the goods are delivered.

Each factor is given equal weight, and if a factor is missing, the remaining factors are given equal weight.

Adoption of a uniform act such as this probably would require joint efforts on the part of the States and Congress. If Congress, acting alone, passed such a law, enforcement might be difficult because the states might resent intrusion by the Federal Government.

The law further limits itself to net income tax. Of the fifty states, plus the District of Columbia, fourteen do not levy a net income tax, so let us eliminate these states from consideration. They are Maine, New Hampshire, West Virginia, Ohio, Michigan, Indiana, Illinois, Florida, Texas, Nebraska, South Dakota, Wyoming, Nevada and Washington State. Now wait—let's not eliminate Michigan too hurriedly. In April of this year, the Michigan Supreme Court upheld a tax on interstate commerce for Michigan Business Receipts tax purposes because Michigan allows certain deductions in determining the amount subject to tax. Apparently, this takes it out of the gross receipts tax class, and puts it into the income tax class. This case may go to the United States Supreme Court, and it is anyone's guess what the outcome will be.

There are six other states that levy a tax measured by income, but these states are franchise tax states. They are Connecticut, Massachusetts, Montana, New Jersey, New York, and Vermont. Now, a franchise is a privilege, or right, granted by the government, and the privilege concerned here is granted to a corporation to engage in business. The fact that the amount of tax payable is measured by the amount of net income does not change the character of the tax, nor does it make it a tax on net income. A word of caution about New Jersey and New York. The New Jersey law reads, ". . . for the privilege of having or exercising its corporate franchise in this State, or for the privilege of doing business, employing or owning capital or property, or maintaining an office . . .." Now, if maintaining an office in New Jersey for merely soliciting sales or for any other purpose subjects a corporation to the New Jersey tax, no practical difference exists because this is the minimum act necessary to lose immunity to income taxation according to Northwestern-Stockham, and the total income would be apportioned to New Jersey on the basis of the New Jersey apportionment formula, whether the business be interstate, or intrastate.

With regard to New York, its law reads "For the privilege of exercising its franchise or doing business . . .." If a corporation is "doing business" in New York, it is subject to the New York franchise tax. However, the term "doing business" is comprehensive and includes all activities which lead toward a profit. And it is immaterial whether the activity results in a profit or a loss. Consideration is given to the following in determining whether a corporation is doing business in New York:

1. Nature and extent of activities compared with activities elsewhere.

2. Purpose for which the corporation was organized compared with its activities in New York.

3. Location of offices and other places of business.

4. Continuity, frequency and regularity of activities in New York compared with continuity, frequency and regularity of activities elsewhere.

5. Employment in New York of agents, officers and other employees.

6. Location of actual seat of management or control.

Ownership of real estate in New York will, in itself, bring the corporation under New York laws.

These items are of particular interest to our textile manufacturing clients. New York City is, and for a number of years has

been, the center of the textile market. If the manufacturer has an office in New York which does nothing but solicit orders, it may not be subject to the New York tax, but it is not unusual for a New York sales office to be in charge of, or responsible for, styling, designing and even production scheduling. Salesmen sometimes call on delinquent accounts to expedite collections, to examine defective goods, and to make or recommend adjustments. Activities such as these may be sufficient to classify the corporation as doing business in New York, and therefore subject to the tax.

Returning to the Supreme Court's decision, let's consider the meaning of "sufficient nexus" or connection. This seems to be clear if the facts and circumstances in Northwestern-Stockham are considered. It appears that soliciting orders plus some other act or acts results in the loss of immunity from state taxes on income. The law allows solicitation of orders by independent contractors, but this is going to require further definition and clarification.

Consider the following circumstances: Two companies have sales offices in, say, Minneapolis, but for some reason, they decide to close them. On the day following the closing, a new firm of independent contractors opens for business in the same city. The sales activities of the two closed offices are transferred to this firm. The new firm holds itself out as a commission agent and regularly advertises in the local papers that it is so engaged. On investigation it develops that the employees and officers, or principals, of the new firm are the same individuals previously employed in the two closed offices. The new firm meets the definition of independent contractor. Its two clients no longer have offices, or property, or perform any acts within the state, and accordingly are immune to the state's income taxes. This obviously is a sham, and the state no doubt will attack it.

Now, consider the exact opposite situation of ABC Sales Company in Atlanta, Georgia. This firm is a long established and highly regarded commission agency. It handles a line of vending machines, snow plows and room air-conditioners. The air-conditioners are manufactured by the XYZ Corporation, in Philadelphia, Pennsylvania, and sales are substantial. The snow plow manufacturer goes bankrupt and the vending machine manufacturer merges with an electronics company. These two accounts are closed, leaving ABC Sales Company soliciting orders for the sale of tangible personal property for only one principal. No longer does it meet the definition of an independent contractor. Does

this expose XYZ Corporation to Georgia income taxes? Perhaps, but probably no more so than before. The current trend of Court decisions tends to indicate that the Commerce Clause no longer means what it meant when it was drafted. And taxpayers who relied thereon in conducting what they thought was interstate commerce are finding themselves taxed on income derived from such operations.

On March 21, 1960, about six months after the present law was enacted, the United States Supreme Court rendered a decision in which it held ". . . the only incident of this sales transaction that is nonlocal is the acceptance of the order. True, the salesmen are not regular employees of appellant, devoting full time to its service, but we conclude that such a fine distinction is without constitutional significance. The formal shift in the contractual tagging of the salesmen as "independent" neither results in changing his local function of solicitation nor bears upon the effectiveness of local solicitation in securing a substantial flow of goods into Florida . . . moreover, we cannot see, from a constitutional standpoint, that it was important that the agent worked for several principals." This quotation is from the case of *Scripto, Inc. v. Carson*. Florida does not levy an income tax and this case relates to the liability of Scripto, Inc. for Florida use taxes which it failed to collect from customers. It appears that use of independent contractors is sufficient nexus to bring a corporation under the control of a foreign state's laws to the extent of requiring it to pay taxes whether or not it collects from buyers. This nexus probably is enough to bring the corporation under the control of state laws for state income tax purposes. Or is it possible for sufficient nexus to exist for one type of tax and not for another?

Shortly after the Northwestern-Stockham decision, several of the income tax states announced that they would be guided by that decision in the application of their income taxes. The trend continues. In January of this year, the Pennsylvania Supreme Court indicated that Pennsylvania corporation income tax law may be applied to foreign corporations engaged exclusively in interstate commerce to the fullest extent permitted by the Northwestern-Stockham decision and the federal statute limiting taxation of interstate income. In the past, the court prevented application of the tax to interstate business. In April, the Michigan Supreme Court upheld a tax on interstate commerce for Michigan gross receipts tax purposes.

Several states felt that their income tax laws were not sufficiently broad to cover this situation. For example, in March, Virginia changed its income tax law. Previously, the standard for determining tax liability of foreign corporations was "doing business." It is now "having income from sources." This becomes effective in 1960. At about the same time, Virginia modified its allocation formula to generally conform to the uniform act for allocation of income proposed by the National Conference of Commissioners on Uniform State Laws. This change is effective after 1961. In April, South Carolina amended its laws to remove any doubt as to the applicability of the Northwestern decision. In February, an announcement by the North Carolina Department of Revenue indicated that it would go along with the Northwestern-Stockham decision. This announcement went even further and emphasized that maintaining inventories in North Carolina, whether on private premises or in public warehouses, is considered doing business in North Carolina, for both income and franchise tax purposes. If this announcement means what it seems to with regard to inventories, it may result in undue and perhaps unintended hardships. To illustrate: A small independent textile converter has his office and only place of business in New York City. Substantially all his customers are dress manufacturers in New York City. He buys grey goods in the open market and some are shipped to a finishing plant in North Carolina where they are stored for him and held waiting receipt of dye orders. Upon receipt of such orders, the plant finishes the goods, packages them, and stores them for the converter until shipping orders are received. Some of these goods may be stored by the finishing plant for a year or more but are the property of the converter at all times. The total value of the goods maintained in North Carolina may be small and the revenue collectible by North Carolina negligible.

The illustrations given here touch on only a few of the problems involved. The area of uncertainty resulting from Northwestern-Stockham and the new law is so large that all of the problems cannot be foreseen. In drafting the law Senator Keating said, "No matter how this bill is worded, we are not going to put the courts or the lawyers out of business."

Now where does this leave us? If our engagement includes preparation of tax returns, we will find ourselves right in the middle—and very soon. We may have to decide whether or not

a tax return is required. To this end it is suggested that every client be considered and an attempt made to determine the status of each. As a guide, but only as a guide, prior year work papers may indicate an office or a stock of goods in a foreign state. In addition, knowledge of the client's business operations may lead to the conclusion that activities other than mere solicitation of orders are being performed. If any one of these conditions exist, the entire situation should be reviewed with the client. It may be necessary to recommend that the client's attorney be consulted. In doubtful cases, and there will be many of them, we should consider recommending the filing of returns under protest, and filing claims for refund pending enactment of a more comprehensive and explicit law.

In examining financial statements for the purpose of giving an opinion, consideration should be given to the possibility of liability for these additional state income taxes. If the liability exists, the amount should be disclosed in the statements even if based on an estimate. Some clients may contend that these taxes are unconstitutional and decline to include them in their records. In this event, consideration should be given to the materiality of the amount. If the amount is not significant, a balance sheet note should suffice. On the other hand, if, as was true in the case of Northwestern States Portland Cement Company, the amount of business conducted in interstate commerce is a substantial percentage of the whole (Northwestern's was approximately half of its total sales) and the liability is not disclosed in the financial statements, it will be necessary to make an exception in our opinion. It is suggested, subject to approval of the partner in-charge, that something along the following lines be used as a balance sheet note:

"No provision has been made for possible additional state income taxes resulting from activities in interstate commerce. These additional taxes are estimated to be approximately $ x x."

If the amount is material and an exception is taken, consider this:

"In our opinion, except as to such additional state income taxes as may result from interstate activities, estimated to be $ x x, the accompanying balance sheet etc."

Finally, a request. If confronted with this situation, please attach a note to the report manuscript so the review department will be aware of it.

New Developments in the Field of Taxation

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The endless array of changes continually occurring in the Federal income tax law renders practice within this area a fascinating, though frustrating, experience. The astounding rapidity with which this takes place and its relation to the experience in the field of general law has been illustrated by a comparison of a minute hand on a clock with the hour hand, the minute hand representing the tax law and the hour hand the general law.

It has been estimated that approximately 30,000 rulings of the Internal Revenue Service and decisions in litigated cases were issued during the course of the past year, a truly formidable array to the tax specialist who seeks to find some semblance of order in this welter of confusion.

Some of the changes have occurred as a result of statutory revision, some because of decided cases, and some result from a change in administrative policy or emphasis.

Recognizing the utter futility of seeking to keep abreast of the entire stream of current or proposed tax legislation and regulations, we shall undertake to choose for consideration those developments that appear of the greatest importance from our point of view as practicing certified public accountants. With this purpose in mind, we shall engage in a discussion of the following topics:

Traveling and Entertainment Expenses
Changes in Accounting Methods
The Dealer Reserve Question
Percentage Depletion
Pension Plans for Members of Professions
Embezzlement Losses

Traveling and Entertainment Expenses

Needless to say, no discussion of recent developments in the tax field would be complete without an effort to deal with the perennial question of traveling and entertainment expenses. We have heard a consistent hue and cry about the tax free benefits inuring to individuals in a manner not intended by the income tax laws through their failure to account properly for expense allow-

ances. In spite of proposals of drastic preventive measures, apparently very little had been accomplished except to focus increased attention upon these abuses. Finally action is being taken by the Commissioner, through the announcement of new reporting requirements which should materially increase the Government's ability to deal with this problem.

It is now proposed that every corporation shall list in a schedule on its Federal income tax return the amount of the expenses reimbursed to its twenty-five highest paid officers, provided that the amount of the reimbursement, when added to the salary or other compensation of the officer amounts to $10,000 or more for the year. If the corporation does not have twenty-five officers, the rule will be applied to the officers that it has, subject to the $10,000 limitation.

The amounts to be shown in this schedule are to include all expenses reimbursed to these individuals or paid for their account directly or through credit cards. The accounting will merely tabulate the total amounts paid for this purpose to each one of the officers listed thereon, and this requirement must first be met on income tax returns for the calendar year 1960 and for the fiscal year 1961.

Upon examination of the return, this information will be reviewed and the examining officer who investigates the matter for the Government will seek to ascertain whether or not the employer has followed sound business practice in requiring an accounting for these amounts by the employees. If the accounting practice is sound, the matter will probably be dropped at this point. If the prevailing practice is not acceptable, the returns of the individual officers will be requisitioned to consider the manner in which the reimbursed expenses are treated thereon. They will be required to report the entire amount thus received as income and allowed to deduct therefrom the expenses that can be properly and reasonably substantiated.

Sound business practice will call for an accounting that will reflect the date of the expenditure in question, the amount, its nature, and its connection with the company's trade or business. In deciding upon the effectiveness of the accounting procedure, the Revenue Agents may consider reimbursement for the use of an automobile up to 12½¢ a mile as reasonable and amounts up to $15 per diem as satisfactory for room and meals in the case of overnight travel.

Partnerships will likewise be required to submit this information with respect to the twenty-five partners who are most highly compensated, taking into account all classes of ordinary income received from the partnership. This is also limited to those whose partnership income, increased by the expense reimbursement, amounts to $10,000 or more for the year. The same rule will be applied to proprietorships with respect to its five highest paid employees as well as to the proprietor himself, the information pertaining to the employees being required only in the case of those who receive $10,000 or more in compensation and expense reimbursement.

Of course, the law on this point remains as it has been in times past. The ruling in the Cohan case, which has long been relied upon by the Government as well as by the taxpayer is still in effect; i.e., that when it is established that the taxpayer has incurred traveling and entertainment expenses, some amount must be allowed, although in the absence of adequate records, estimates may be relied upon that lean heavily against the taxpayer "whose inexactitude is of his own making." Sometimes, it appears that some taxpayers do better with inexactitude than with exactitude, no matter how much they may be "leaned against." The law has not been changed, but the Commissioner's reporting requirement appears to constitute the most definite step taken in a program of more thorough enforcement and I do not believe it can be properly ignored.

Changes in Accounting Methods

It would seem that when a taxpayer through error relies upon an incorrect method of accounting to arrive at his taxable income, he should be permitted to make the change to an acceptable method on some reasonable and sensible basis. Unfortunately, good common sense seems to have played a comparatively minor role in the field of income taxation and it appears that once a person has become enmeshed in the complexities of an erroneous accounting practice, the Internal Revenue Service and the courts have conspired to make it as difficult as possible for him to extricate himself.

Under rules formerly prevailing, it was almost impossible to effect a change on a reasonable and equitable basis. It all began under the 1939 Internal Revenue Code when the Commissioner undertook to apply the decision of the Second Circuit Court of

Appeals in the *Hardy* case to any taxpayer who was reporting on the cash basis when he should have been using the accrual basis.

It was well established under the regulations that a taxpayer must necessarily report on the accrual basis if accounts receivable and inventories constitute material income-producing factors. Since many such taxpayers improperly reported on the cash basis, the Commissioner undertook under the *Hardy* case to add to the taxpayer's income, for the year of the enforced change to the accrual basis, the accounts receivable and inventories at the close of the year without setting up similar assets at the beginning of the year. Finally, after a series of court cases, some semblance of order began to appear out of the ensuing chaos, but it was order of a questionable type. In those cases where the taxpayer voluntarily made the change, he was taxed on the opening receivables and inventory in the year of the change; when the Commissioner enforced the change, he was not. Doubtless, there was some very profound reason for this approach, for its eventual outcome of course could have been predicted with certainty by any novice in the field of taxation. Naturally, the taxpayer would just refrain from making any change in his system of accounting and require the Commissioner to correct it. The Commissioner, afraid of the impact of the recent Tax Court decisions, would likewise avoid the change.

The 1954 Internal Revenue Code contained Section 481 which was supposed to eliminate this difficulty. It provides that any change in accounting method as the result of permission granted by the Commissioner must be accomplished in a manner that will prevent the duplication of taxable income, the duplication of deductions, the elimination of taxable income, and the loss of allowable deductions. It contained a mystifying provision, however; in explaining the transitional adjustments that are to be made, the law provided that "there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply." Confusion was thus rather unexpectedly increased, for immediately the taxpayer believed that his transition from the cash to the accrual basis could be effected without paying any income tax on the receivables and inventory at the end of 1953. Applications were filed for permission to change under

this section and because the drafters of the regulations in the National office of the Internal Revenue Service were as confused as the taxpayer and his representatives, they were held in abeyance. In some instances, letters were sent by the Internal Revenue Service in answer to timely applications informing the applicant that because of the incompleteness of the regulations the request could not be presently ruled upon, but that after the regulations were issued, the application should be reopened for consideration upon request properly submitted by the taxpayer. In the meantime, Section 29 (a) of Public Law 85–866 amending Section 481 (a) of the Code was passed in 1958 to provide that the portion of the law exempting adjustments relating to pre-1954 years "Does not apply unless the adjustment is attributable to a change in method of accounting initiated by the taxpayer." This amendment applies to any change in accounting method when the year of change is a taxable year beginning after December 31, 1953 and ending after August 6, 1954. It has no application, however, if before September 2, 1958, the taxpayer sought permission for a change in method of accounting in the manner provided by regulations and the taxpayer and the secretary or his delegate agreed to the terms and conditions for making the change.

Special relief provisions permitted the taxpayer to tax the income resulting from the transitional adjustment, other than that resulting from the pre-1954 adjustments, on the basis of the tax that would apply if one-third of the income were received in the current year and one-third in each of the two preceding years. The pre-1954 adjustments which are taxable only when the taxpayer himself initiates the change may be taxed on the basis of a ten-year taxable period following the complicated set of rules set forth in Section 481 (b) (4) (A) and (B).

Some misunderstanding has arisen regarding the nature of the pre-1954 adjustments. The impression seems to prevail in some quarters that the elimination of this portion which is nontaxable when the Commissioner initiates the change is effected by undertaking to ascertain the accounts receivable having an origin prior to 1954 that are still in existence in the year of change. Let us assume for example that a change from the cash to the accrual method is forced upon the taxpayer by the Government in the year 1957. The accounts receivable at that date amount to $100,000, of which $10,000 represents a balance outstanding at December 31, 1953. According to a popular view, this $10,000

is the entire amount that is to be eliminated from income in the year 1957 when the change is made. This is not the position taken by the regulations. Let us assume in this problem that although the 1953 accounts receivable amounted to $10,000 at the beginning of 1957, they actually amounted to $50,000 at December 31, 1953. This $50,000 is the figure to be eliminated, not the $10,000. Of course, the effect of such an arrangement is self-evident.

It is hard to advise a client to correct his accounting method from a cash to an accrual basis when there appears to be a premium on the maintenance of the old improper method. Also, it is natural that the Commissioner should be very hesitant to require the change if thereby he loses the tax on a substantial amount of income.

The Dealer Reserve Question

The much controverted Dealer Reserve question finally came to rest upon the decision of the Supreme Court in the *Hansen* case. This dispute which had raged for a long period had arisen concerning the income tax status of Dealer Reserves in those cases where automobile dealers sold notes from customers to a finance company. The finance company would then hold back a portion of the balance due the dealer and in addition might set aside a portion of the finance charge on the paper otherwise due the dealer. The question arising was whether the reserve constituted income to the dealer in the year of the sale of the cars and of the transfer of the installment paper to the finance company, or when the cash was actually received from the finance company.

It has been finally settled that this income is taxable to an accrual basis taxpayer when the sale is made and not at the time the cash is finally received. As a result, problems have arisen regarding manner of effecting changes or adjustments, when these automobile dealers are required to bring their accounting treatment of this item into accord with the *Hansen* case. Public Law 86–459 entitled "The Dealer Reserve Income Adjustment Act of 1960" has just been passed to provide a means of accomplishing this change. It may be available to any taxpayer on the accrual basis who elects to have its provisions applied if this election is made before September 1, 1960. It sets forth alternative approaches to this problem. If the first method is selected, the taxpayer elects to apply Section 3(a) of the law and makes the adjustment in the

most recent taxable year ending after June 22, 1959. He takes into income for that year the difference between the Dealer Reserve balance at December 31, 1959 and this balance at December 31, 1953 or at any year prior to 1953 if it is not barred by the Statute of Limitations. If the resulting income adjustment exceeds $3,000, the taxpayer may determine the tax attributable to the change by spreading the income evenly over the year of change and the two preceding years, paying this total tax when it is lower than would be the result if the adjustment were taxed entirely at current year rates.

The alternative to this approach calls for the determination of the tax for each year that was open at June 21, 1959. After the tax is thus computed and a deficiency or overassessment is determined for each year involved, interest is computed thereon from the due date of each return up to the date of the election. The sum of the amounts and interest would represent the amount of the payment that is due, which can be made on the due date in 1961 for filing the 1960 return. If it exceeds $2,500, it may be paid in up to ten equal annual installments, beginning at the due date of the 1960 return. If this alternative is used, no interest is to be paid with respect to the deferred amount beyond the due date of the election to apply this method.

*Percentage Depletion—Brick and Tile Industry**

For a number of years after the passage of the law allowing percentage depletion to the brick and tile industry at the rate of 5%, the Government had insisted that the percentage be applied to a relatively small portion of the sales price of brick. It determined this so-called "income from mining" by apportioning the sales price on the basis of the ratio of cost up to the pug mill operation to the total cost of producing the brick. After a long series of adverse decisions and the refusal of the Supreme Court to grant certiorari the Treasury announced in 1947 that it would follow the Circuit Court's decision in *U. S.* v. *Merry Brothers Brick & Tile Company* and that it was giving consideration to the application of the principle involved in that decision to fire clay and limestone. On June 27, 1960 the Supreme Court handed down its decision in *U. S.* v. *Cannelton Sewer Pipe Company.* In this

*The *Cannelton* case was not decided at the time this discussion was originally presented; however, because of its great significance, this paper is amended to give effect to this decision.

case the Government took the position that fire clay itself and shale suitable for fire brick constitute marketable mineral products. The depletion rates involved were 15% for fire clay and 5% for shale.

The Court ruled that the proper basis for applying percentage depletion in the case of this integrated miner-manufacturer of burnt clay products was the value of its raw fire clay and shale after the application of the ordinary treatment processes normally applied by nonintegrated miners recovering those minerals. The Court's finding was based on the existence of a substantial market in the taxpayer's locality for fire clay and shale in their raw state and it applied the provisions of the 1939 Code corresponding to the 1954 Code Section 613(c)(4)(C) which specifies the ordinary treatment processes to be taken into consideration in arriving at the income from mining. The Court held that a different result should not be reached merely because the taxpayer could not sell its minerals at a profit in their raw state.

This decision may require a reexamination of methods used in computing "gross income from the property" for percentage depletion purposes, not only by producers of raw fire clay and shale but by other taxpayers whose depletion allowances have been based upon the sales of a "commercially marketable mineral product." In some cases the "commercially marketable mineral product" under the general rule of Section 613(c)(2) of the 1954 Code or the corresponding provision of the 1939 Code has been a finished product such as brick, tile, or cement.

The decision may affect computation for 1960 and all prior open years since the applicable provisions of the 1954 Code are substantially the same as those in the 1939 Code, under which this case was decided. For years beginning after December 31, 1960 the law has been amended eliminating the "commercially marketable mineral product" test, providing instead the allowance of certain specified treatment processes which are to be taken into account in determining the basis for applying the percentage depletion.

It is believed that the case of the brick and tile manufacturers is very much stronger than the *Cannelton* case since it has been generally conceded in the decisions in point that there is no clearly established market for brick and tile clay, although such a market does exist for fire clay. It appears that the shale which was considered in the *Cannelton* case to be marketable came from a vein

below the fire clay and was also of great plasticity, capable of enduring extreme heat. In this respect it is completely different from the shale used in the manufacture of ordinary brick, for which there appears to be no market. Without a substantial market for the mineral in its crude state it appears that the effect of the Cannelton case is doubtful; however, what course the Treasury will now follow with respect to the percentage depletion problem in the brick and tile industry is unknown at present.

Pension Plans for Members of Professions

A most serious question faced by professional men generally has been a means of providing for retirement on a satisfactory basis. Since all income resulting from professional services is subject to normal and surtax, an accumulation for the future is very difficult and a professional taxpayer finds himself at a financial disadvantage by comparison with corporate employees because of his inability to set aside an amount in a pension trust. The very fact of his proprietorship renders such a trust an impossibility under existing income tax laws and he has consistently sought ways and means to remedy this state of affairs.

A group of doctors sought to solve this problem in the *Kintner* case.

The physicians involved were not permitted by law to incorporate; however, the income tax law has consistently provided that where an unincorporated organization possesses certain prime characteristics of a corporation, it should be treated as one for income tax purposes. The doctors therefore sought to establish an association which, because of its attributes would result in the imposition of corporate Federal income tax and would for this reason be entitled to establish a qualified pension or profit-sharing plan. The group won this case in the Federal District Court, and although the Treasury has long refused to follow the decision, it now appears according to Revenue Ruling 57-546 that it is prepared to do so in cases where the professional organization meets requirements of an association taxable as a corporation. The primary qualifying factors are:

(1) Continuity of the life of the organization.

(2) Centralized management.

(3) Limited liability.

(4) Transferability of interest.

The Treasury Departmnet indicates that if more than two of these factors are present, the organization may constitute an association, although it has not committed itself to any position if no more than two of these factors are involved.

The tax status of an association has usually been applied to a limited partnership or a Massachusetts business trust with transferable shares.

Obviously an organization of this type cannot have continuity of life if it is dissolved under the State law upon the death or withdrawal of a partner; however, the uniform partnership law is in effect in both Virginia and North Carolina, which provides for the continuation of a partnership under these circumstances if the partnership agreement provides therefor.

To qualify under the centralized management factor, it is necessary to show that this management control is centered in a group smaller than that comprising all of the members. A primary requirement is that the manager must have sole authority to make the decisions without having to obtain ratification by vote of the membership.

The law in effect in Virginia and North Carolina likewise provides that any partnership having limited partners must have one or more general partners whose liability is not limited.

Transferability of interest from one person to another can be established in a manner that may be acceptable to the other partners involved by giving the right of first refusal to the other members of the organization before the transfer takes place.

Of course, none of these arrangements are simple and the danger is always present if any organization should seek to establish its present status as that of an association that the Government might insist that it is taxable on this basis, not only in the current year, but in all prior years and call for corporate income tax returns for those years, asserting taxes, penalties and interest. This could be quite serious in the case of a partnership, for it might mean that only the partners' salaries would be allowed as a deduction with the rest of the income taxable at corporate rates. It may be the safest policy, if any group wishes to avail itself of possible pension benefits under this rule, to create an entirely new organization and plan withdrawals in a manner that will serve to take from the entity as a salary, practically the entire income, with the exception of the amount remaining for payment into the pension or profit-sharing trust.

Embezzlement Losses

A number of years ago, the Supreme Court in the case of *Commissioner vs. Wilcox* held that money improperly abstracted by an embezzler does not constitute taxable income to him because he has no semblance of a bona fide claim of right and is at all times "under an unqualified duty and obligation to repay the money to his employer." This resulted in an anomalous situation in which the employer might sustain and deduct a substantial loss based upon such a misappropriation of funds while the person who received and spent them would incur no income tax liability.

The United States Court of Appeals, Seventh Circuit, in the case of Eugene C. James considers that the *Wilcox* case applied only to its particular facts, and takes a different position with respect to Mr. James.

This defendant had obtained $700,000 by misappropriation from a union and an insurance company without reporting any of this amount for Federal income tax purposes. The Court, in taxing this money to James, is basing its position upon the fact that the taxpayer had obtained the economic use and benefit of the funds. This unique question will soon be decided by the Supreme Court of the United States, which granted certiorari in the *James* case on May 16, 1960. It may be possible that a new doctrine will be established in this case which may make embezzling considerably less profitable and no less dangerous than it is at present.

Conclusion

I would not be manifesting any very great wisdom if I should join the chorus of those who cry that the entire income tax law should be discarded, unless I could suggest a fairer and more effective method of taxation. It is much easier to make such a sweeping pronouncement than it is to develop a satisfactory substitute, for with all its present faults, the Federal income tax law does represent the accumulated tax scholarship of many years. Certainly until the happy advent of a new simple and equitable law, we must continue to exercise the utmost vigilance if we seek to follow the ever recurring changes and revisions in the rules of taxation that are brought to pass by the ingenuity of the taxpayer, the Government, and the courts.

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